

Message Text

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E.O. 11652: N/A
TAGS: NI, OVIP (CARTER, JIMMY)
SUBJECT: AMBASSADOR'S LETTER TO SMITH AF/W DEC 12 77

1. EMBASSY WILL SHORTLY TRANSMIT SUGGESTIONS FOR REVISIONS OF PRESIDENTIAL BRIEFING PAPERS SENT TO DEPARTMENT SEVERAL MONTHS AGO. AS PREVIOUS BRIEFING PAPER ON NIGERIAN PETROLEUM SECTOR NEEDED EXTENSIVE UPDATING, WE NOW SEND FOLLOWING REDRAFTED TEXT.

2. NIGERIA IS THE SECOND MOST IMPORTANT SOURCE OF U.S. CRUDE OIL IMPORTS, AFTER SAUDI ARABIA. IN 1977, NIGERIA SUPPLIED THE U.S. WITH 1.16 MILLION BARRELS PER DAY (11 MONTHS AVERAGE) EQUIVALENT TO 16.7 PERCENT OF U.S. CRUDE OIL IMPORTS. THE DEPENDENCE IS MUTUAL: IN 1977, U.S. PURCHASES ACCOUNTED FOR 56.3 PERCENT OF NIGERIA'S EXPORTS OF JUST OVER 2 MILLION BARRELS PER DAY. NIGERIA EARNED \$9.7 BILLION FROM OIL EXPORTS IN 1977. SINCE OIL EXPORTS ACCOUNT FOR FULLY 85 PERCENT OF NIGERIAN GOVERNMENT REVENUES, IT IS CLEAR THAT THE COUNTRY IS DEPENDENT ON THE U.S. FOR THE BULK OF ITS DEVELOPMENT RESOURCES.

3. THOUGH NOT A HAWK IN OPEC PRICE DELIBERATIONS NIGERIA
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HAS CONSISTENTLY FAVORED PRICE RATHER THAN PRODUCTION INCREASES AS A MEANS OF MAXIMIZING DEVELOPMENT REVENUES. THROUGHOUT 1976, NIGERIA RAISED ITS PRICES ALMOST EVERY QUARTER, SUCCESSFULLY RIDING A WAVE OF INCREASING DEMAND FOR LIGHT WEIGHT, GASOLINE RICH, LOW SULPHUR CRUDE OILS. HOWEVER, IN APRIL 1977, NIGERIA POSTED A PRICE INCREASE WHICH WAS NOT FOLLOWED BY PRODUCERS OF SIMILAR CRUDES LIKE

ALGERIA, LIBYA, INDONESIA AND THE NORTH SEA. THIS ALSO OCCURED AT A TIME WHEN REFINERS WERE HOLDING EXCESS STOCKS OF GASOLINE PRODUCED DURING THE BITTER PRECEDING WINTER, AND NEW SUPPLIES OF LIGHT CRUDE OIL FROM THE NORTH SEA AND ALASKA WERE ENTERING THE MARKET. THUS, NIGERIA OVERPRICED ITS OIL IN THE FACE OF WEAKENING DEMAND. A SMALL PRICE REDUCTION IN JANUARY WAS INSUFFICIENT TO RESTORE PROFITABILITY, AND CUSTOMERS UNDERSTANDABLY DECLINED TO RENEW CONTRACTS OBLIGING THEM TO PURCHASE GOVERNMENT OWNED OIL WHEN THEY EXPIRED IN OCTOBER AND DECEMBER. AS A RESULT, OIL EXPORTS IN JANUARY 1977 WERE 21 PERCENT BELOW THE PREVIOUS JANUARY, AND EASILY 550,000 BARRELS PER DAY LESS THAN CAPACITY.

4. THIS SITUATION WILL SEVERELY CONSTRAIN NIGERIA'S ABILITY TO FINANCE ITS AMBITIOUS DEVELOPMENT PLANS. WHILE THE NIGERIAN NATIONAL PETROLEUM CORPORATION MAY ADJUST I4S PRICES FURTHER IN THE QECOND QUARTER, IT APPEARS THAT DEMAND FOR LIGHT CRUDE OILS WILL REMAIN WEAK THROUGHOUT 1978. MOREOVER, ONCE CUSTOMERS HAVE FOUND SATISFACTORY ALTERNATIVE SOURCES OF SUPPLY OR INVESTED IN DESULFURIZATION FACILITIES, THEY MAY BE LOST TO NIGERIA FOR GOOD. BASED ON AVERAGE EXPORTS FOR OCTOBER-JANUARY, A PERIOD WHEN CUSTOMERS WERE NO LONGER OBLIGATED TO LIFT OIL THEY DID NOT WANT, PROJECTED REVENUES FOR 1978 AMOUNT TO ONLY \$8.2 BILLION. THIS IS LOWER THAN EARNINGS FOR 1974. IN CONTRAST, WHEN THE ORIGINAL 1975-80 DEVELOPMENT PLAN WAS FORMULATED, IT WAS LIMITED OFFICIAL USE

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ANTICIPATED THAT OIL EXPORT REVENUES WOULD BY NOW BE RUNNING AT AN ANNUAL RATE OF OVER \$14 BILLION.

5. THOUGH OIL EXPLORATION BEGAN IN NIGERIA IN 1937, THE FIRST DISCOVERY WAS NOT MADE UNTIL 1956. PRODUCTION BEGAN IN 1958 AND EXCEPT FOR THE PERIOD DURING THE CIVIL WAR (1967-1970) GREW RAPIDLY AND REACHED A PEAK OF 2.36 MILLION BARRELS PER DAY IN JUNE 1974. PRODUCTION DECLINED TO 1.55 MILLION BARRELS PER DAY IN MAY 1975, RECOVERED STEADILY TO 2.26 MILLION BARRELS PER DAY IN APRIL 1977, AND CURRENTLY HAS SLUMPED TO AN ESTIMATED 1.58 MILLION BARRELS PER DAY IN FEBRUARY. THE OLDEST AND LARGEST PRODUCER IS A DUTCH-BRITISH JOINT VENTURE BETWEEN SHELL AND BP. OTHER COMPANIES INCLUDE GULF, MOBIL, AGIP/ PHILLIPS, TEXACO/CHEVRON, ELF, PAN OCEAN, AND ASHLAND.

6. THE LONG TERM DECLINE OR LEVELLING OFF IN PRODUCTION SINCE MID-1974 IS MAINLY THE RESULT OF NIGERIAN GOVERNMENT ACTIONS WHICH CREATED AN UNFAVORABLE INVESTMENT CLIMATE. THE FMG ACQUIRED A 55-PERCENT SHAREHOLDING IN THE MAJOR OIL PRODUCING COMPANIES IN 1974, FOR WHICH THE COMPANIES WERE NOT COMPENSATED UNTIL DECEMBER 1976, AND RAISED TAXES AND ROYALTY RATES IN 1975, SHARPLY DEPRESSING PROFIT MARGINS.

NIGERIA'S PETROLEUM RESERVES OF ABOUT 19 BILLION BARRELS ARE SUBSTANTIAL BUT REQUIRE CONSTANT DEVELOPMENT DRILLING SINCE MOST PRODUCTION COMES FROM SMALL FORMATIONS WITH SHORT LIFE SPANS. THE COSTS AND RISKS ARE THUS HIGH, AND INVESTMENT IN OIL EXPLORATION AND DEVELOPMENT IN NIGERIA WAS MADE COMPARTIVELY UNATTRACTIVE.

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7. IN MAY 1977 THE NIGERIAN GOVERNMENT ANNOUNCED A PACKAGE OF IMPROVED FISCAL INCENTIVES DESIGNED TO

ENCOURAGE RENEWED INVESTMENT IN EXPLORATION AND DEVELOPMENT. THESE INCLUDED ACCELERATED DEPRECIATION, TAX CREDITS WHICH INCREASE AS THE COST OF PRODUCTION INCREASES, LOWER ROYALTY RATES FOR OFFSHORE PRODUCTION, EXPENSING THE OFVDCAT AND FIRST TWO APPRAISAL WELLS IN A SUCCESSFUL NEW FIELD INSTEAD OF CAPITALIZING THEM, A 14 PERCENT INCREASE IN PER BARREL PROFIT MARGINS, AND A LOWER TAX RATE FOR NEW OIL PRODUCERS UNTIL PRE-PRODUCTION COSTS HAVE BEEN RECOVERED. THESE INCENTIVES RAISED THE NET RETURN ON INVESTMENT FROM AN UNATTRACTIVE 7 OR 8 PERCENT TO AROUND 12 OR 13 PERCENT, AND ACCELERATED COMPANY CASH FLOWS. THE OIL COMPANIES RESPONDED VERY FAVORABLY, PLANNING TO DOUBLE OR TRIPLE INVESTMENT BUDGETS ORIGINALLY SET FOR THIS YEAR. ONE AMERICAN COMPANY FORESAW INVESTING AS MUCH AS \$1 BILLION (55 PERCENT OF WHICH WILL COME FROM THE NIGERIAN NATIONAL PETROLEUM CORPORATION) OVER THE NEXT SEVEN YEARS.

8. HOWEVER THE OUTLOOK FOR FUTURE OIL INVESTMENT IS CLOUDED BY SEVERAL ADVERSE FACTORS. WHILE THE NEW LIMITED OFFICIAL USE

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PMKNDIVES HAVE STIMULATED INVESTMENT ONSHORE, AND IN OFFSHORE WATERS UP TO ABOUT 80 ETRES DEEP, THEY DO NOT PROVIDE RETURNS COMMENSURATE WITH THE RAPID ESCALATION OF COSTS AND RISKS IN DEEPER OFFSHORE AREAS WHERE NIGERIA WILL HAVE TO LOOK FOR MOST OF ITS FUTURE RESERVES. IN ADDITION, ALTHOUGH THE COMPENSATION CLAIMS OF THE COMPANIES FOR THE GOVERNMENT'S ACQUISITION OF A 55-PERCENT INTEREST WERE SATISFACTORILY SETTLED AND PAID NEARLY A YEAR AGO, THE GOVERNMENT HAS NOW INFORMED THE COMPANIES THAT IT WISHES TO RE-EXAMINE THE AGREEMENTS, BELIEVING THAT THROUGH INEXPERIENCE IT GAVE THEM BETTER TERMS IN 1974 THAN THEY RECEIVED IN OTHER COUNTRIES. THE EFFECT WOULD BE TO CUT IN HALF THE COMPENSATION PAID TO THE COMPANIES. FINALLY, THE OIL COMPANIES HAVE LITTLE INCENTIVE TO INVEST IN NEW PROCTION FACILITIES WHILE WEAK WORLD DEMAND AND RIGID NIGERIAN PRICING POLICIES KEEP THEIR EXISTING CAPACITY UNDERUTILIZED.

9. OIL POLICY IN NIGERIA IS DETERMINED BY THE SUPREME MILITARY COUNCIL, ONE OF WHOSE MEMBERS, COLONEL MUHAMMED BUBARI, IS COMMISSIONER FOR PETROLEUM AS WELL AS CHAIRMAN OF THE BOARD OF THE NIGERIAN NATIONAL PETROLEUM CORPORATION (NNPC), AND NIGERIA'S CHIEF REPRESENTATIVE AT OPEC. THE NNPC ABSORBED BOTH THE FORMER NATIONAL OIL COMPANY AND THE FORMER MINISTRY OF PETROLEUM RESOURCES THIS YEAR.

10. NIGERIA JOINED OPEC IN 1971. THOUGH A NIGERIAN, CHIEF M. O. FEYIDE, SERVED AS OPEC SECRETARY GENERAL IN 1975-76, NIGERIA HAS NEVER PLAYED A MAJOR ROLE IN THE ORGANIZATION. NIGERIA DID NOT JOIN THE ARAB KWNZJRCM AGAINST THE U.S. IN 1973. ALTHOUGH THE QUESTION HAS ARISEN IN U.S. GOVERNMENT CIRCLES WHETHER NIGERIA MIGHT CONSIDER CUTTING OFF OIL SALES TO THE U.S. IN A DISPUTE OVER SOUTH AFRICAN POLICY, LIMITED OFFICIAL USE

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THIS IS HIGHLY DOUBTFUL IN VIEW OF THE COUNTRY SUPRN SING NEED FOR DEVELOPMENT REVENUES AND LACK OF ALTERNATIVE SOURCES OF INCOME. IN FACT, NIGERIAN OFFICIALS HAVE BEEN KNOWN TO EXPRESS THE OPPOSITE CONCERN, THAT THE U.S. MIGHT STOP BUYING NIGERIAN OIL FOR POLITICAL REARONS, AND THAT NIGERIA IS THEREFORE TOO DEPENDENT ON THE U.S. MARKET.

11. IN ADDITION TO OIL, NIGERIA HAS SUBSTANTIAL GAS RESERVES, CONSERVATIVELY ESTIMATED AT 60 TRILLION CUBIC FEET. THE GOVERNMENT HAS PLANS TO BUILD A LIQUIFIED NATURAL GAS FACILITY IN PARTNERSHIP WITH PHILLIPS PETROLEUM OF THE U.S., SHELL, BP, AGIP AND ELF, AND HOPES TO SELL THE LNG TO THW U.S.

MARKET. THE NIGERIAN GOVERNMENT HOPES FOR RAPID ACTION WHEN IT EVENTUALLY FILES AN APPLICATION WITH THE FPC, AND IS INTENSELY INTERESTED IN THE OUTCOME OF THE GAS PRICING ISSUE IN PRESIDENT CARTER'S ENERGY POLICY.

12. ONE DEVELOPMENT WHICH IS OF GREAT CONCERN TO THE U.S. OIL COMPANIES OPERATING IN NIGERIA, BUT WHICH HAS NOT YET BEEN FOCUSED ON BY THE NIGERIAN NATIONAL PETROLEUM CORPORATION, IS A RECENT RULING BY THE U.S. INTERNAL REVENUE SERVICE THAT AMOUNTS RECEIVED BY LIBYA FROM U.S. OIL COMPANIES OPERATING IN THAT COUNTRY ARE NOT FOREIGN INCOME TAXES AND THEREFORE MAY NOT BE CREDITED AGAINST U.S. INCOME TAXES. THIS RULING AFFECTS U.S. OIL COMPANIES IN ALL COUNTRIES. SAUDI ARABIA, WE UNDERSTAND, HAS ALREADY MADE ADJUSTMENTS IN ITS POSTED PRICE, THE PRICE AGAINST WHICH TAXES ARE CALCULATED, TO RELIEVE U.S. OIL COMAPNIES OF THE BIND IN WHICH THIS RULING PLACED THEM. WHETHER NIGERIA WILL CONSIDER SIMILAR RELIEF IS UNKNOWN. HOWEVER, WE UNDERSTAND THAT THE U.S. OIL COMPANIES WISH TO INCLUDE THIS TOPIC ON THE AGENDA OF THE BILATERAL ECONOMIC TALKS WHICH ARE SLATED TO FOLLOW THE PRESIDENT'S VISIT.

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